

Before the  
**FEDERAL COMMUNICATIONS COMMISSION**  
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
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In the Matter of )  
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Extension Of Section 272 Obligations )  
Of Southwestern Bell Telephone Co. )  
In The State Of Texas )  
\_\_\_\_\_ )

WC Docket No. 03 \_\_\_\_\_

02-112

**PETITION OF AT&T CORP.**

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## GLOSSARY OF COMMISSION ORDERS

SHORT CITE	FULL CITE
<i>Accounting Safeguards Order</i>	First Report and Order, <i>Implementation of the Telecommunications Act of 1996: Accounting Safeguards</i> , 11 FCC Rcd. 17539 (1996)
<i>Ameritech-SBC Merger Order</i>	Memorandum Opinion And Order, <i>Applications Of Ameritech Corp., Transferor, And SBC Communications Inc., Transferee, For Consent To Transfer Control Of Corporations</i> , 14 FCC Rcd. 14712 (1999)
<i>Bell Atlantic-GTE Merger Order</i>	Memorandum Opinion And Order, <i>Application Of GTE Corp., Transferor, And Bell Atlantic Corp., Transferee, For Consent To Transfer Control</i> , 15 FCC Rcd. 14032 (2000)
<i>LEC Classification Order</i>	Second Report and Order, <i>Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area</i> , 12 FCC Rcd. 15756 (1997)
<i>New York 271 Order</i>	Memorandum Opinion and Order, <i>Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York</i> , 15 FCC Rcd. 3953 (1999)
<i>Non-Accounting Safeguards Order</i>	First Report and Order and Further Notice of Proposed Rulemaking, <i>Implementation of Non Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended</i> , 11 FCC Rcd. 21905 (1996)
<i>SBC Merger Violation Consent Decree</i>	Order, <i>SBC Communications Inc.</i> , File No. EB-02-IH-0382 (Enforcement Bureau, March 20, 2003).
<i>Texas 271 Order</i>	Memorandum Opinion and Order, <i>Application by SBC Communications Inc., et al Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Texas</i> , 15 FCC Rcd. 18354 (2000)
<i>UNE Remand Order</i>	Third Report and Order, <i>Implementation of the Local Competition Provisions of the Telecommunications Act of 1996</i> , 15 FCC Rcd. 3696 (1999)

<i>272 Sunset Notice</i>	Notice of Proposed Rulemaking, <i>Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements</i> , WC Docket No. 02-112 (rel. May 24, 2002)
<i>272 Sunset Order</i>	Memorandum Opinion and Order, <i>Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements</i> , WC Docket No. 02-112 (Dec. 23, 2002)

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**PETITION OF AT&T CORP.**

AT&T Corp. ("AT&T") respectfully submits this Petition and requests that the Commission extend application of the separate affiliate and other safeguards of 47 U.S.C. § 272 to Southwestern Bell Telephone Co. ("SWBT") in Texas for an additional three years.

**INTRODUCTION AND SUMMARY**

On July 10, 2003, it will have been three years since SWBT's Texas local markets were deemed "open" to competition and SWBT was authorized to provide interLATA services in that state. SWBT, which already claims to control a 35 percent and growing share of long distance traffic in Texas, has flourished under this new regime; local competition has not. Through this Petition, AT&T requests that the Commission exercise its authority under section 272(f) of the Communications Act, 47 U.S.C. § 272(f), and find that SWBT's enduring local market power in Texas requires the continuation of the "crucial[ly] importan[t]"<sup>1</sup> separate affiliate and other obligations that Congress and the Commission have recognized remain necessary in a state so long as the Bell operating company ("BOC") in that state retains substantial market power.

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<sup>1</sup> *Texas 271 Order* ¶ 395.

Specifically, AT&T urges the Commission to order that existing section 272 safeguards will remain necessary in Texas for at least an additional three years. The Public Utility Commission of Texas ("Texas PUC") has already strongly urged the Commission to extend the section 272 requirements, an extension that is all the more necessary given the significant evidence that SWBT has in fact discriminated against competitors and has engaged in improper cost misallocation.

Section 272 requires a BOC to offer interLATA services only through a truly separate affiliate that must "operate independently" from and on an "arm's length" basis with the BOC.<sup>2</sup> The long distance affiliate must maintain "separate" "books, records, and accounts" from the BOC, utilize "separate officers, directors, and employees" from the BOC and make available for public inspection "any" transactions between the BOC and its affiliate.<sup>3</sup> And section 272 contains a number of conduct safeguards designed to detect anticompetitive discrimination and cross-subsidization, including an unqualified prohibition against discrimination by a BOC in its dealings with its affiliate and requirements that the BOC fulfill various requests for service by competitors on the same terms that the BOC provides to itself or its affiliates.<sup>4</sup>

Congress imposed these requirements in recognition of the undeniable fact that, upon receipt of section 271 authorization, a BOC's local markets in a state will be merely "open" to competition and that a substantial – although indeterminate – time will pass before competition sufficient to constrain the exercise of market power by the BOC can develop.<sup>5</sup> In the interim, the

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<sup>2</sup> 47 U.S.C. § 272(b)(1-3).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* §§ 272(c), (e).

<sup>5</sup> *Non-Accounting Safeguards Order* ¶ 9 ("In enacting section 272, Congress recognized that the local exchange market will not be fully competitive immediately upon its opening.").

section 272 safeguards are designed to enable regulators to detect and deter post-271 efforts by a BOC to leverage its local market power into competitive interLATA markets. As the Commission has stressed, these safeguards are clearly necessary so long as the BOC retains substantial market power, because the BOC has incentives, *inter alia*, “to discriminate in providing exchange access services and facilities that its [long distance] affiliate’s rivals need to compete in the interLATA telecommunications services and information services markets.”<sup>6</sup> “This artificial advantage may allow the BOC affiliate to win customers even though a competing carrier may be a more efficient provider in serving the customer.”<sup>7</sup> The section 272 structural, accounting and nondiscrimination safeguards are targeted to detect and prevent such market power abuses and thereby to “ensure that competitors of the BOC’s [long distance] affiliate have access to essential inputs, namely, the provision of local exchange and exchange access services, on terms that do not discriminate against competitors and in favor of the BOC’s affiliate.”<sup>8</sup>

Because Congress could not know in advance how long it would take actual price-constraining competition to develop in a particular state after local markets were finally opened to competition – competition that would eliminate the BOC’s ability and incentive to leverage anticompetitively its local network facilities – it provided that section 272 would apply for a *minimum* of 3 years after a BOC received section 271 authority.<sup>9</sup> But Congress recognized the possibility that a BOC’s market power might not dissipate that quickly, and it provided the

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<sup>6</sup> *Non-Accounting Safeguards Order* ¶ 11.

<sup>7</sup> *Id.* ¶ 12.

<sup>8</sup> *Id.* ¶ 13.

<sup>9</sup> 47 U.S.C. § 272(f)(1).

Commission with authority to extend those requirements by rule or by order.<sup>10</sup> And it is for precisely these reasons that the Commission concluded in 1996 in its initial orders implementing section 272 that its section 272 rules would remain in place “until facilities-based alternatives to the local exchange and exchange access services of the BOCs make those safeguards no longer necessary.”<sup>11</sup>

There is no legitimate dispute that there are no significant facilities-based alternatives to SWBT’s local exchange and access services in Texas, and, as a result, the section 272 safeguards remain necessary. As the Texas PUC – the regulatory body that is most knowledgeable about the state of local competition in Texas – has expressly found, SWBT retains substantial local market power. And, for that reason, the Texas PUC has already strongly urged the Commission to extend the section 272 requirements:

The Texas PUC believes that . . . SWBT’s continued dominance over local exchange and exchange access services still hinders the development of a fully competitive market[s] . . . Thus, SWBT retains both the incentive and ability to discriminate against competitors and to engage in anti-competitive behavior. . . . Accordingly, prudence demands that the sunset period be extended until the conditions which necessitated the creation of competitive safeguards no longer exist.<sup>12</sup>

Given the hard facts, no other conclusion could be reached. As the Commission has recognized, the type of competition most relevant for purposes of determining whether section 272 obligations should sunset is *facilities-based* competition.<sup>13</sup> This is because the BOC’s ability

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<sup>10</sup> *Id.*

<sup>11</sup> *Non-Accounting Safeguards Order* ¶ 13.

<sup>12</sup> Texas PUC 272 Sunset Comments at 3, WC Docket No. 02-112, (filed July 25, 2002) (“Texas PUC 272 Sunset Comments”).

<sup>13</sup> See *Non-Accounting Safeguards Order* ¶ 13 (section 272, and implementing rules and policies, would apply “until *facilities-based* alternatives to the local exchange and exchange access services of the BOCs make those safeguards no longer necessary”) (emphasis added).



anticompetitively to harm rivals is based on its control of the bottleneck network facilities that are necessary for the provision of interLATA services. So long as rival interLATA providers must rely on the BOC's facilities to obtain exchange access services, the BOC will retain the ability (and obvious incentives) to raise rivals' costs and restrict rivals' output.<sup>14</sup> As the most recent report issued by the Texas PUC shows, there is virtually no facilities-based competition in Texas.<sup>15</sup> And the Commission's own recently announced findings concluding the Triennial Review Proceeding (WC Docket No. 01-338) explain why: self-deployment of key local network facilities is, in the vast majority of circumstances, uneconomic because of enormous entry barriers.<sup>16</sup>

But SWBT's overwhelming market power in Texas is clear even with a focus on non-facilities-based competition. According to the most recent data compiled by the Texas PUC, competitive carriers are actually *losing* market share and now serve less than 15 percent of lines in Texas.<sup>17</sup> At the same time, scores of competitive carriers have been pushed into bankruptcy in Texas.<sup>18</sup> In stark contrast, SWBT has steadily increased its interLATA long distance market share to more than 35 percent.<sup>19</sup>

Allowing the section 272 safeguards to "sunset" in this environment would be profoundly anticompetitive and contrary to the public interest. So long as SWBT enjoys substantial local

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<sup>14</sup> See *LEC Classification Order* ¶¶ 100, 158; *Non-Accounting Safeguards Order* ¶¶ 9-13.

<sup>15</sup> *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 20-22, (available at [www.puc.state.tx.us/telecomm/reports/scope/index.cfm](http://www.puc.state.tx.us/telecomm/reports/scope/index.cfm)).

<sup>16</sup> See, e.g., News Release, *FCC Adopts For Network Unbundling Obligations Of Incumbent Local Phone Carriers* (Feb. 20, 2003); *UNE Remand Order* ¶ 182.

<sup>17</sup> *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 20.

<sup>18</sup> *Id.* at 17.

<sup>19</sup> *Id.* at 12.

market power, it will have the ability to act on its clear incentives to discriminate and cross-subsidize in favor of its long distance operations. This is not mere speculation. As confirmed by the biennial section 272 audit of S WBT's Texas operations, S WBT and its sister-BOCs have engaged in substantial discrimination and cross-subsidization notwithstanding the limits and transparency imposed by the section 272 safeguards.<sup>20</sup> If no such safeguards were in place, this anticompetitive conduct would only escalate.

Finally, even if there could be any precedential value to the Commission's entirely unexplained (and unjustifiable) decision not to extend the section 272 safeguards in New York, the relevant circumstances in the two states are very different. There has been much less deployment of bypass facilities by competitive carriers in Texas than in New York.<sup>21</sup> Likewise, competitive carriers have won far more customers and market share in New York (already upwards of 25 percent) than in any other state;<sup>22</sup> in Texas, by contrast, competitors have attained very limited and now declining market shares.<sup>23</sup> The Texas PUC has expressly requested that the Commission extend the 272 obligations in Texas; the New York Public Service Commission did

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<sup>20</sup> AT&T hereby incorporates its January 29, 2003 comments submitted in CC Docket No. 96-150 in connection with SBC's biennial audit report.

<sup>21</sup> There are 200,000 more competitive-carrier owned lines (which include leased loops when connected to competitive carrier switches) in New York than in Texas. See *Local Telephone Competition: Status as of June 30, 2002*, Table 8 (Industry Analysis and Technology Div., Wireline Competition Bureau, Dec. 2002) ("*Local Telephone Competition*"). In fact, facilities-based competition in Texas is below the national average. *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 23.

<sup>22</sup> According to the most recent Commission data, competitive carriers serve 25 percent of access lines in New York, compared with approximately 15 percent in Texas. *Local Telephone Competition*, Table 7 ; *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 19-20.

<sup>23</sup> *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 20.

not. And Verizon in New York made clear that it had no plans to merge its separate long distance affiliate into its BOC;<sup>24</sup> SWBT has made no such commitment in Texas.

In sum, the Commission has a clear responsibility to act here. Given SWBT's continuing market power in Texas, it would be an abdication of the Commission's duty to protect competition and consumers to allow SWBT's section 272 obligations to sunset. The Commission should extend SWBT's section 272 obligations for an additional three years.

## **ARGUMENT**

### **I. THE SECTION 272 SAFEGUARDS REMAIN CRITICALLY IMPORTANT IN TEXAS.**

In light of the indisputably slow pace of local competition growth in Texas, the section 272 safeguards remain as necessary today as they were when SWBT was first granted section 271 authority. Until local competition in Texas is far more robust, SWBT will continue to have both the incentive and ability to discriminate in favor of its long distance affiliates and to leverage its dominance into downstream markets. Although the section 272 safeguards do not eliminate this problem – nothing less than full structural separation could accomplish that – they do provide an important regulatory tool for detecting (and thereby deterring) such anticompetitive conduct.

Indeed, the records developed in the WC Docket No. 02-112 (the Section 272 Sunset Proceeding) and CC Docket No. 96-150 (the SBC Biennial Audit Proceeding) confirm that the need for the continuance of the core section 272 safeguards in Texas is just as great now as when SWBT first entered the long distance market nearly three years ago. The evidence from these proceedings demonstrates that SWBT has engaged in a disturbing and persistent pattern of discrimination and cross-subsidization aimed at harming its long distance rivals. Without the

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<sup>24</sup> See New York PSC 272 Sunset Comments at 1, WC Docket No. 02-112 (filed Aug. 5, 2002).

section 272 safeguards, there would simply be no “means of monitoring [SWBT]’s obligation to provide access to its network” and detecting or deterring such market power abuses.<sup>25</sup>

**A. Retention Of Section 272 Safeguards Is Necessary To Promote Competition In Texas.**

Section 272 was enacted to address the problem created by the fact that the BOCs were permitted to provide in-region long distance services merely by *opening* their local markets. Section 272 thus reflects Congress’ recognition that, even after a BOC is permitted to provide in-region interLATA service in a state, it will continue to have substantial market power in its local markets in that state. Section 272 targets the core concern that the BOC will leverage this local market power both to undermine existing competition in the long-distance market and to stifle fledgling competition in those local markets.

For these reasons, the Commission has frequently stressed that “compliance with section 272 is of crucial importance because the structural, transactional, and nondiscrimination safeguards of section 272 seek to ensure that BOCs compete on a level playing field.”<sup>26</sup> Among other obligations, section 272 requires a BOC, after obtaining section 271 authority, to provide long distance and other services through independent and separate affiliates and to afford competing carriers the same treatment it provides to these affiliates.<sup>27</sup> In particular, these separate affiliate and related requirements are “designed, in the absence of full competition in the local exchange marketplace, to prohibit anticompetitive discrimination and cost-shifting.”<sup>28</sup> And, as the Commission has previously recognized, such restrictions lie at the very heart of the

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<sup>25</sup> See Texas PUC 272 Sunset Comments at 6.

<sup>26</sup> *Texas 271 Order* ¶ 395 (citation omitted).

<sup>27</sup> See 47 U.S.C. § 272.

<sup>28</sup> *Non-Accounting Safeguards Order* ¶ 9.

Act.<sup>29</sup> The section 272 safeguards are designed to reveal (and discourage) BOC discrimination against interLATA competitors and in favor of their own long-distance affiliates and BOC subsidization of those long-distance affiliates by recovering the affiliates' costs from local and exchange access customers.<sup>30</sup> In the absence of those safeguards, a BOC with local market power could, with virtual impunity, act on its incentives to engage in such discrimination and cross-subsidization.

These concerns apply with particular force in the case of SWBT. In its *Ameritech-SBC Merger Order*, the Commission found that the combination of Ameritech and SBC *heightened* the combined entity's "incentive to discriminate" against independent long distance carriers and that this incentive is "particularly acute with regards to advanced or customized access services for which detection of discrimination is most difficult."<sup>31</sup> Moreover, in that merger proceeding the Commission rejected the claim that regulators have developed proper tools to detect and prevent discrimination by SBC and its BOC subsidiaries: "With the increased network complexity, and the possibility for new types of discrimination, comes also an increased difficulty in detecting discrimination. In such a situation, past experience with the

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<sup>29</sup> E.g., *Ameritech-SBC Merger Order* ¶¶ 12-16, 190; *Non-Accounting Safeguards Order* ¶ 9, 11-13; see also *id.* ¶¶ 1-63, 216.

<sup>30</sup> SBC has claimed that fears of cost misallocation and cross-subsidization are a "relic from the past," particularly because the BOCs today operate under a "pure price cap regime." SBC 272 Sunset Comments at 13, WC Docket No. 02-112 (filed Aug. 5, 2002) ("SBC 272 Sunset Comments"). However, as AT&T has shown in detail, BOCs still retain incentives and ability to misallocate costs under price cap regulation. AT&T 272 Sunset Reply Comments, Selwyn Reply Dec. ¶¶ 30-37, WC Docket No. 02-112 (filed Aug. 26, 2002) ("AT&T 272 Sunset Reply Comments"). The risk of BOC discrimination and cost misallocation is therefore, far more than a theoretical concern – it presents a real and substantial threat to the great "strength of competition in the interexchange market." *Ameritech-SBC Merger Order* ¶ 213.

<sup>31</sup> *Id.* ¶ 196; see also *id.* ¶¶ 212-35.

interconnection of plain vanilla, or POTS service, becomes increasingly less useful as a regulatory tool for preventing, detecting, and remedying discrimination.”<sup>32</sup>

It is to prevent such abuses and protect interLATA markets that the “crucial[ly] importan[t]” section 272 safeguards must remain in effect until competition has sufficiently developed to dissipate SWBT’s market power.<sup>33</sup> Further, as the Commission has recognized, the most relevant competition for purposes of determining whether section 272 obligations should sunset is *facilities-based* competition enabled by deploying alternative facilities.<sup>34</sup> The ability and incentive of the BOCs’ to discriminate against rival carriers flows from their control over local facilities that are essential to competition. Thus, regardless of competitive carriers’ retail “market share,” so long as competitive carriers remain dependent upon BOC facilities to provide services to customers, a BOC can raise its rivals’ costs and restrict its rivals’ output by denying and/or delaying access to essential network inputs and by engaging in cross-subsidization and price squeezes.<sup>35</sup> Indeed, this is true even when the competitive carrier uses its own facilities in connection with leasing BOC facilities. For example, even if a competitive carrier serves a customer using its own switch, it still must lease BOC-provided loops and the BOC has the incentive and ability to give that carrier an inferior quality loop, to slow-roll provisioning of the

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<sup>32</sup> *Id.* ¶ 220.

<sup>33</sup> AT&T 272 Sunset Comments at 7-10, WC Docket No. 02-112 (filed Aug. 5, 2002) (“AT&T 272 Sunset Comments”); *see also* 272 Sunset Notice ¶ 12 (the Commission could “support the sunset of [section 272] statutory requirements” only if and only when competitive “circumstances [have] changed in three years”) (emphasis added).

<sup>34</sup> *See Non-Accounting Safeguards Order* ¶ 13 (section 272, and implementing rules and policies, would apply “until *facilities-based* alternatives to the local exchange and exchange access services of the BOCs make those safeguards no longer necessary”) (emphasis added).

<sup>35</sup> *See LEC Classification Order* ¶¶ 100, 158; *Non-Accounting Safeguards Order* ¶¶ 9-13; *see also Verizon Communications, Inc. v. FCC*, 122 S. Ct. 1646, 1662 (2002) (“*Verizon*”) (the carrier that controls the “local -loop plant” could “place conditions or fees . . . on long-distance carriers seeking to connect with its network”).

loop, and to charge supra-competitive prices for the loop. That is why the state commissions – including the Texas PUC – have argued that the Commission should require a showing of fully competitive markets and alternative sources of supply before considering the removal of section 272 safeguards.<sup>36</sup>

And in this regard, there is no serious dispute that such significant and fully robust local competition in Texas has yet to emerge. Indeed, because competition in Texas lags far behind competition in New York, extending the section 272 requirements in Texas would be appropriate even assuming that the Commission properly allowed – which it did not – those requirements to sunset in New York. Far more than in New York, competitive carriers in Texas remain highly dependent upon SWBT to provide local telephone services in that state, as well as to originate and terminate long distance and broadband services that they provide. According to the Texas PUC, only 3 percent of lines in Texas are served by competitive carriers using their own local networks.<sup>37</sup> These data are fully consistent with the Commission’s own findings. In concluding its Triennial Review Proceeding, the Commission has reconfirmed its prior findings<sup>38</sup> that in the

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<sup>36</sup> Texas PUC 272 Sunset Comments at 3 (“[P]rudence demands that the sunset period be extended *until the conditions which necessitated the creation of competitive safeguards no longer exist*”) (emphasis added); *see also* Washington UTC 272 Sunset Comments at 2, WC Docket No. 02-112 (filed Aug. 5, 2002) (“Washington UTC 272 Sunset Comments”) (Commission should not “lift[] the safeguards too soon,” i.e., before “robust, sustainable competition . . . develop[s]”); Missouri PSC 272 Sunset Comments at 3, 4, WC Docket No. 02-112 (filed Aug. 5, 2002) (“Missouri PSC 272 Sunset Comments”) (retain safeguards “until such time as the BOC no longer has an incentive and the ability to discriminate against long distance competitors or to engage in other anti-competitive conduct”).

<sup>37</sup> *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 20-22. Indeed, while the overall number of lines served by competitive carriers in Texas exceeds the national average, the percentage of lines that are facilities-based in Texas *trails* the national average. *Id.* at 23. Notably, there are 200,000 more “facilities-based” competitive lines in New York than in Texas. *Local Telephone Competition*, Table 8.

<sup>38</sup> *See, e.g., UNE Remand Order* ¶ 182 (“self-provisioning is not a viable alternative because replicat[ion of] an incumbent’s vast and ubiquitous network would be prohibitively expensive and delay competitive entry”).

vast majority of instances, competitive carriers cannot economically self-deploy either transmission facilities (including both ordinary copper facilities and “high capacity” fiber transmission facilities used to serve large customers) or switching facilities to serve “low capacity” residential and small business customers because of “entry barriers” that include “scale economies, sunk costs, first-mover advantages, and barriers within the control of the incumbent LEC.”<sup>39</sup> As the Supreme Court just explained, “[i]t is easy to see why a company that owns a local exchange . . . would have an almost insurmountable competitive advantage not only in routing calls within the exchange, but, through its control of this local market, in the market[] for . . . long-distance calling as well.”<sup>40</sup>

But even considering all retail local competition, there can still be no debate that SWBT faces much less retail competition in Texas than Verizon in New York as a result of SWBT’s anticompetitive conduct (which is shown more fully in the next section). According to the most recent statistics compiled by the Texas PUC, competitive carriers *lost* local market share in Texas in 2002 and now serve only 15 percent of lines.<sup>41</sup> Similarly, competitive carrier revenues “have . . . flattened out.”<sup>42</sup> These figures are not likely to improve given the fact that between 1999 and 2002, 47 competitive carriers operating in Texas have declared bankruptcy (with seven

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<sup>39</sup> News Release, *FCC Adopts For Network Unbundling Obligations Of Incumbent Local Phone Carriers* (Feb. 20, 2003).

<sup>40</sup> *Verizon*, 122 S. Ct. at 1662.

<sup>41</sup> *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 20.

<sup>42</sup> *Id.* at 18.



being liquidated to date).<sup>43</sup> Again, these figures contrast with New York where competitive carriers have captured fully 25 percent of exchange access lines, the most in the nation.<sup>44</sup>

The conclusion that SWBT has market power in Texas is shared by the regulator with, in the Commission's own words, the greatest "expertise" with local competitive conditions in Texas – the Texas PUC.<sup>45</sup> According to that agency, SWBT through its control of bottleneck facilities has "continued dominance over local exchange and exchange access services" that enables it to "hinder[] the development of a fully competitive market."<sup>46</sup> And as a result of this market power, "SWBT retains both the incentive and ability to discriminate against competitors and to engage in anti-competitive behavior."<sup>47</sup> Having accorded "substantial weight"<sup>48</sup> to the Texas PUC's views on whether SWBT's local markets were "open" to competition, it would be arbitrary agency action for the Commission now to simply ignore the Texas PUC's express findings that SWBT enjoys substantial local market power and that the section 272 safeguards therefore remain essential.

In short, there is overwhelming real world evidence that SWBT's local market power has not been significantly reduced, even three years after it won approval pursuant to section 271 to offer in-region, interLATA services. Until SWBT's market power has dissipated, the reasons for

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<sup>43</sup> *Id.* at 17.

<sup>44</sup> See *Local Telephone Competition*, Table 7. It is also notable that since it has been granted section 271 relief, SWBT has steadily increased its long distance market share to 35 percent. *Scope of Competition in Telecommunications Markets of Texas* (Texas PUC Jan. 2003) at 12; see also *id.* at 15 ("SWBT entered the long-distance market in July 200. Two years later, Southwestern Bell Corporation (SBC) has made significant progress in the long-distance market while competition in the local market is still emerging, and many competitors of SWBT are struggling to remain financially viable.").

<sup>45</sup> *Texas 271 Order* ¶ 4.

<sup>46</sup> Texas PUC 272 Sunset Comments at 3.

<sup>47</sup> *Id.* at 3.

<sup>48</sup> *Texas 271 Order* ¶ 4.

each of the section 272 requirements remain, and no rational basis exists for finding that either the public interest or competition will be served by their elimination.

**B. SWBT Continues To Misallocate Costs And To Discriminate Against Unaffiliated InterLATA Competitors.**

There is no need to guess as to whether SWBT has market power in Texas that can be used to harm interLATA competition. The evidence from the Section 272 Sunset Proceeding, SBC's biennial audit, the most recent competition report issued by the Texas PUC, and the Enforcement Bureau's investigation of SBC's compliance with the *Ameritech-SBC Merger Order* conditions, shows that SWBT and its sister-BOCs have cross-subsidized their long distance affiliates and discriminated against unaffiliated interLATA providers.<sup>49</sup> As a matter of simple logic, much more anticompetitive conduct is a certainty if the Commission were to permit existing section 272 safeguards to sunset.

Specifically, the record from the Section 272 Sunset Proceeding shows that SWBT and its sister BOCs have used a variety of anticompetitive strategies to harm long distance competition, including discrimination in the provisioning of access to their essential network facilities, abuse of the PIC change process, discriminatory growth tariffs, and engaging in improper inter-affiliate transfers.<sup>50</sup> Perhaps of greatest concern, however, is the mounting evidence that SWBT is "price squeezing" its competitors. As AT&T explained in a complaint with the Texas PUC, SWBT's long distance affiliate began offering intrastate long distance services at rates that are nearly equal to SWBT's intrastate *access charges* and that therefore could not possibly allow the SWBT

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<sup>49</sup> See AT&T 272 Sunset Comments at 21-44.

<sup>50</sup> See *id.*

affiliate to cover all of its costs, as required by section 272(e).<sup>51</sup> There is clearly no way for AT&T and other long distance carriers to compete on the merits when they are being charged nearly as much for the access component of long distance than SWBT is charging at retail for the entire long distance service.<sup>52</sup>

More recent evidence from the Commission's biennial audit of SBC and the Texas PUC's investigation of local competition in Texas confirms that these abuses are not isolated instances, but are part of an ongoing pattern and practice of anticompetitive conduct by SWBT. The recent audit of SBC, despite being improperly narrow,<sup>53</sup> confirms pervasive discrimination by SBC in clear violation of section 272. For example, with regard to completion of DS0 orders by the required due date, the performance data (which SBC sought to keep secret) show that SBC's affiliates received better performance in *each* of the last seven months audited – and the largest differences were in the last two months reported, confirming that SBC's performance was decreasing.<sup>54</sup> The data also show that SBC's return interval for firm order confirmations on DS1

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<sup>51</sup> See Second Amended Complaint of AT&T Communications of Texas, L.P., *Complaint of AT&T Communications of Texas, L.P. Against Southwestern Bell Telephone Company and Southwestern Bell Communications, Inc., d/b/a Southwestern Bell Long Distance*, SOAH Docket No. 473-01-1558, Docket No. 23063 (Texas PUC filed Dec. 5, 2001) (“*AT&T Price Squeeze Complaint*”). The Texas PUC found that it did not have jurisdiction over the complaint – a finding that AT&T disputes. Regardless of whether the PUC is correct, AT&T still believes that the substance of its complaint has merit.

<sup>52</sup> SWBT's willingness to harm competition by misallocating costs of its section 272 affiliate was dramatically made clear in testimony by a SWBT witness before the Texas legislature. The testimony related to proposed tax legislation that would eliminate the ability of a surviving corporation in a merger to carry forward the losses of the other merged company. The SWBT witness stated that SWBT plans to merge its affiliates into its BOC operations when it is permitted, and that SWBT will want to use the *losses* of those companies to offset any profits of the BOC. Partial Tr., Before the Senate Comm. on Finance, Austin, Texas, *Relating to the Franchise Tax*, S. Bill 1689 (Testimony of T. Leahy, SBC, Apr. 19, 2001).

<sup>53</sup> In its comments, the Texas PUC explained that the SBC audit was fundamentally defective and could not be relied upon to show SBC's compliance with section 272. See generally Texas PUC SBC Biennial Audit Comments; see also AT&T SBC Biennial Audit Comments at 16-32.

<sup>54</sup> See *id.* at 20.

and DS3 facilities was longer for SBC's rivals than for its affiliates in *all* 18 of the instances where the measure employed showed a performance difference.<sup>55</sup> Likewise, for restoration of trouble, by both measures SBC's competitors virtually always suffered longer delays than SBC's affiliates.<sup>56</sup> The auditor's report likewise details numerous violations by SBC of its section 272 obligations to, *inter alia*, operate independently from its affiliates, to keep separate books, records and accounts, to maintain separate employees, and to conduct affiliate transactions on an arms-length basis.<sup>57</sup>

The January 2003 report from the Texas PUC reviewing the effectiveness of the performance measures enacted in Texas likewise shows that SWBT continues to find it advantageous to provide its competitors with poor network access, even if it means paying steady fines. SWBT has met the performance benchmarks set by the Texas PUC in only 6 out of 31 months for which data are now available.<sup>58</sup> As of July 2002, SWBT had paid over \$25 million in fines, an amount that would have been higher but for the fact that the Texas performance measure penalties cap payments in certain months.<sup>59</sup>

Finally, in order to settle the Enforcement Bureau's investigation of SBC's adherence to the *Ameritech-SBC Merger Order* conditions, SBC has effectively conceded that it has been discriminating against competitors that would use unbundled network elements to provide exchange access. Specifically, SBC just last month agreed to pay \$250,000 to settle the Bureau's

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<sup>55</sup> See *id.* at 19-20.

<sup>56</sup> See *id.* at 24.

<sup>57</sup> See *id.* at 25-32.

<sup>58</sup> *Scope of Competition in Telecommunications Markets -of Texas* (Texas PUC Jan. 2003) at 50.

<sup>59</sup> *Id.* at 52.

investigation of its failure to provide monthly performance measures that show that it provides competitors' access to its network equivalent to which SBC itself enjoys.<sup>60</sup>

When vigorously enforced, section 272 can play a significant role in detecting whether such anticompetitive conduct is occurring.<sup>61</sup> For example, the requirement that the BOC maintain a separate affiliate and maintain separate books and records in accordance with GAAP allows regulators and competitors to detect price squeezes<sup>62</sup> – indeed, AT&T relied on section 272 disclosure requirements to provide a factual basis for its claims.<sup>63</sup> The requirement that BOCs post summaries of their affiliate transactions gives regulators and competitors information that is relevant to determining whether a BOC affiliate is being charged an appropriate rate for the goods or services it obtains from the BOC, and how the affiliate's costs are aligned with the rates the affiliate is charging others.

The requirement that the BOC maintain a separate affiliate and deal with that affiliate on an arm's length basis is an essential method for determining whether SWBT is discriminating against rivals. As the Pennsylvania PUC reports, the separate structure and accounting

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<sup>60</sup> *SBC Merger Violation Consent Decree* ¶ 13.

<sup>61</sup> As AT&T has explained, the protections of section 272 are unique and other regulatory protections, such as existing ARMIS regulations and equal access obligations, are not sufficient to detect and prevent discrimination and cost-shifting. AT&T 272 Sunset Reply Comments at 20-22; *see also* Washington UTC 272 Sunset Comments at 3 (section 272 safeguards "provide necessary consumer and competitive protections that cannot otherwise be obtained." ).

<sup>62</sup> *Accounting Safeguards Order* ¶ 9.

<sup>63</sup> Some of the plans offered by SWBT's long distance affiliate offer long distance service for as low as 6 cents per minute for residential customers. *AT&T Price Squeeze Complaint* at 6-7. Yet the access charge that applies to a residential intrastate long distance call between SWBT customers is about 5.67 cents per minute. *Id.* at 7. On such calls, SWBT's affiliate gains net revenue of just a few tenths of a cent. However, it is evident that the affiliate's own operating expenses are significant, and along with the access cost, far exceed the retail rates that SWBT's affiliate is charging. Based upon agreements that SWBT has summarized as a result of its section 272 obligations, AT&T was able to estimate that the SWBT long distance affiliate incurs billing and marketing expenses of at least 3.4 cents per minute. *Id.* at 8. Based on these pricing  
(continued . . .)

provisions of section 272 “assist[]” state regulators in their “ability to design rates,” and the “ability to readily identify costs and revenues from the business segment is *critical* to ongoing rate review.”<sup>64</sup> And more generally, the Pennsylvania PUC shows that the collapse of separate affiliate requirements would “perpetuate[] what appears to be a continual reduction in available information.”<sup>65</sup> Indeed, as the Texas PUC has explained, these non-accounting safeguards are the “*only* statutory means of monitoring [SWBT]’s obligation to provide access to its network.”<sup>66</sup>

Finally, when properly designed and implemented, there is no substitute for Congressionally-mandated biennial audits for detecting discrimination and cost-shifting by BOCs. Both state regulators<sup>67</sup> and the Commission have stressed the importance of biennial audits and the need for such audits to be conducted so as to provide “*stringent* post-entry oversight” and a “*thorough and systematic* evaluation” of a BOC’s treatment of competitors.<sup>68</sup> Indeed, the Commission has found such audits to be “critical” to local competition:

Commission guidance of the audit process is crucial to assuring that the accounting and structural safeguards are in place and functioning properly. Because of the critical nature of accounting safeguards in promoting competition in the telecommunications market and the *critical role* the biennial audit will play

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(... continued)

patterns, AT&T alleged that SWBT’s long distance rates were below-cost, result in a price squeeze, and are anticompetitive. *Id.*

<sup>64</sup> Pennsylvania PUC 272 Sunset Comments at 5, WC Docket No. 02-112 (filed July 22, 2002) (“Pennsylvania PUC 272 Sunset Comments”) (emphasis added).

<sup>65</sup> *Id.* at 4.

<sup>66</sup> See Texas PUC 272 Sunset Comments at 6.

<sup>67</sup> The Missouri PSC reports that “without the section 272 audit process, there is no way to detect and deter discrimination and anti-competitive behavior.” Missouri PSC 272 Sunset Comments at 4; see Washington UTC 272 Sunset Comments at 3 (“maintaining a separate affiliate makes the audit process easier and provides more transparency to the transactions to be audited”); Pennsylvania PUC 272 Sunset Comments at 4 (“audits can produce useful information for policymakers such as the PUC”).

<sup>68</sup> *New York 271 Order* ¶ 416 & n.1284 (emphasis added).

in ensuring that the safeguards are working, it is essential that we establish effective biennial audit rules at the outset.<sup>69</sup>

And, as Commissioner Martin has observed, it is, to say the least, “odd” for the Commission to sunset section 272 obligations before the sufficiency of the biennial audit process has been established and it is fully known the extent to which the BOCs have, in fact, been discriminating and cost-shifting.<sup>70</sup> Accordingly, before the Commission should even contemplate eliminating core section 272 safeguards, it must revive the biennial audit process and have in the record a rigorous audit that determines the extent to which the BOC in question has complied with its section 272 obligations.

## **II. THE BENEFITS OF EXTENDING THE SECTION 272 SAFEGUARDS CLEARLY OUTWEIGH ANY COSTS THAT THEY MAY IMPOSE.**

Neither SWBT nor any other BOC has ever substantiated their claims that compliance with the section 272 safeguards is particularly costly, much less that those costs outweigh the clear public interest benefits of maintaining the safeguards. To date, only one BOC, Verizon, has even attempted to quantify the supposed costs of section 272 compliance.<sup>71</sup> However, the declarations that Verizon submitted are little more than conclusory statements that opine generally about costs, without any specific discussion of how those costs were derived and

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<sup>69</sup> See *Accounting Safeguards Order* ¶ 197 (emphases added).

<sup>70</sup> 272 *Sunset Order*, Martin Statement at 1. See also Texas PUC SBC Biennial Audit Comments 9 (“The better course would be for the FCC to require compliance with the audit requirements of Section 272 before considering whether to remove a BOC Section 272 affiliate obligations.”).

<sup>71</sup> Verizon 272 *Sunset Comments* at 9-11 & Howard Dec., WC Docket No. 02-112 (filed July 25, 2002) (“Verizon 272 *Sunset Comments*”) SBC’s comments in the 272 *Sunset Proceeding* include unsupported claims that elimination of some section 272 safeguards would result in savings for some SBC departments ranging from 20 to 75 percent. SBC 272 *Sunset Comments* at 7-8. As the Commission has concluded in other proceedings, statements like these that are not reinforced by declaration or other evidence are entitled to little weight.

without any backup material that could be used to verify independently these claims.<sup>72</sup> Moreover, as AT&T has demonstrated with sworn expert testimony, the BOCs have in other contexts commented that the costs of integration are substantial – in the hundreds of millions of dollars – yet here, they provide no information regarding the costs of integration of their section 272 affiliates.<sup>73</sup>

The BOCs' claims that section 272 safeguards prevent them from taking advantage of important economies of integration are particularly disingenuous. The Commission's orders implementing section 272 already have provided numerous opportunities for the BOCs and their section 272 affiliates to share services and take advantage of other economies.<sup>74</sup> Even though these joint activities present risks of anticompetitive behavior, and could also easily have been prohibited entirely, the Commission permitted such activities, which substantially reduced the BOCs' costs of compliance with section 272. In fact, it is obvious that the integration that the Commission has allowed provides significant benefits to the BOCs' section 272 affiliates – surely no other company but a BOC affiliate could only recently begin offering long distance services and capture significant market share by using just 800 employees, as Verizon has done.<sup>75</sup> These facts belie any notion that section 272 compliance costs are significant.

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<sup>72</sup> See AT&T 272 Sunset Reply Comments, Selwyn Reply Dec. ¶¶ 26-27. Verizon unreasonably refused AT&T's request for access, subject to a Protective Order, to any backup material. See, AT&T *Ex Parte* Letter, CC Docket No. 96-149 (January 2, 2003).

<sup>73</sup> AT&T 272 Sunset Reply Comments, Selwyn Reply Dec. ¶ 28.

<sup>74</sup> See, e.g., WorldCom 272 Sunset Comments at 7-9, WC Docket No. 02-112 (filed Aug. 5, 2002) ("WorldCom 272 Sunset Comments"); Time Warner 272 Sunset Comments at 17-20, WC Docket No. 02-112 (filed Aug. 5, 2002).

<sup>75</sup> See WorldCom 272 Sunset Comments at 8; see also AT&T 272 Sunset Reply Comments, Selwyn Reply Dec ¶¶ 6-8.



The Commission's orders approving SBC and Verizon mergers with separate affiliate conditions found that this "structural mechanism" was an effective way to "ensure a level playing field" between a BOC and its rivals.<sup>76</sup> These orders therefore reflect the Commission's determination that separate affiliate structures can be a cost-effective method for preventing discrimination and otherwise policing BOC misconduct.<sup>77</sup> Finally, the section 272 safeguards obligations cannot be considered too costly because other regulatory protections would remain in place, such as ARMIS accounting requirements and equal access obligations. As discussed above, section 272, when properly implemented and vigorously enforced, provides substantial and unique benefits that promote competition in telecommunications markets. As the Texas PUC and other state regulators have explained, if section 272 safeguards are eliminated, they "will lose a valuable means to ensure [the BOC's] compliance with its obligations to provide access to the local exchange and exchange access markets that [the BOC] controls."<sup>78</sup> Eliminating section 272 requirements on this grounds is also contrary to Congress' clear purpose in enacting section 272. Given that most of the rules that the BOCs have cited as obviating the need for section 272 were in effect in 1996, Congress necessarily believed that additional protections were necessary because existing rules would not be effective in policing the BOCs' misconduct and eliminating discrimination and cost misallocation.

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<sup>76</sup> *Ameritech-SBC Merger Order* ¶ 363; see *Bell Atlantic-GTE Merger Order* ¶ 260 ("strict compliance" with a "separate affiliate condition will mitigate the substantial risk of discrimination").

<sup>77</sup> *Ameritech-SBC Merger Order* ¶ 211.

<sup>78</sup> Texas PUC 272 Sunset Comments at 3; see also Pennsylvania PUC 272 Sunset Comments at 5; Missouri PSC 272 Sunset Comments at 3, 4; Washington UTC 272 Sunset Comments at 2.

## CONCLUSION

For the foregoing reasons, the Commission should issue a rule extending application of section 272 to SWBT in Texas for an additional three years.

Respectfully submitted,

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